L. COMMUNITY SERVICE ORGANIZATIONS – RECREATION FACILITIES, HEALTH CLUBS, AND OTHER INCOME PRODUCING ACTIVITIES -- EXEMPTION AND UNRELATED BUSINESS INCOME TAX ISSUES EXAMINED

1. Introduction

The emphasis in today's society on health and fitness has given rise to a proliferation of commercial, for-profit health spas, health and recreation centers, health clubs, fitness centers, and the like. Community service organizations, such as the "Y's," exempt under IRC 501(c)(3) have also placed renewed emphasis on health and fitness programs, exercise centers and gymnasia.

Community service organizations have expanded the scope of services provided to the public to meet perceived community needs, including activities that may be directed to members of the community who are on fixed or limited incomes (the elderly), or are handicapped. Many of these activities may be directly in furtherance of the community service organizations' educational or charitable purposes. On the other hand, many of these program activities may be in new areas and constitute unrelated trade or business activities. If the organization is primarily operated to run an unrelated trade or business, exemption may be jeopardized.

This topic will address community service organization activities, primarily health and recreation programs. The topic will also sketch out other potential unrelated trade or business activities carried on by community service organizations that have been discussed in earlier EO ATRI/CPE textbooks in conjunction with other types of section 501(c)(3) organizations such as museums and universities.

2. Health Clubs

A. Exemption Issues

(1) Community Recreational Facility - General Background and History

Recreation organizations may be either charitable under IRC 501(c)(3) or promoting social welfare under IRC 501(c)(4). They could also be social clubs under IRC 501(c)(7) or non-exempt (taxable) organizations.

One of the earliest cases to consider the issue was the case of Isabel Peters v. Commissioner, 21 T.C. 55 (1953), involving the Eagle Dock Foundation, which purchased a private beach for the use of residents of the Cold Spring Harbor area (Long Island, New York). The operation of the beach was the only activity of the Foundation. Use of the beach was limited to residents of the neighboring communities. No charge was made for the use of the beach. Admission to the beach was by pass. Passes to residents were mailed annually with a request for contributions. Approximately one-third of those who received passes made contributions. The issue in the case involved deductibility of contributions under the predecessor to IRC 170(c)(2). However, the Foundation had been determined by the Service to be exempt as a civic league under the predecessor to IRC 501(c)(4), under which contributions were not deductible. The Tax Court determined in this case that the non-profit operation of Eagle Dock Foundation, and the conferring of a community-wide benefit by the Foundation, entitled it to status as a charitable organization under the predecessor to IRC 501(c)(3) for the year in question, and not merely to exempt treatment as a civic league.

The thinking of the Tax Court in Isabel Peters was not accepted by the Service until 1959, when the Commissioner acquiesced in the decision (1959-2 C.B. 6), and Rev. Rul. 59-310, 1959-2 C.B. 146, was promulgated. Rev. Rul. 59-310 capsulized the Service's thinking in the area. Basically, the Service accepted the conclusion that, in the facts of the particular case, Eagle Dock Foundation was charitable. What the Service wished to avoid, however, as stated in that revenue ruling, was the implication that every non-profit organization dedicated solely to the promotion of social welfare could be classified as charitable under IRC 501(c)(3). The Service was struggling at that time with the issue of fees-for-services and exemption, as indicated in our holding in Rev. Rul. 58-588, 1958-2 C.B. 265.

Rev. Rul. 58-588 involved the issue of whether of health club could be exempt as a social club under IRC 501(c)(7). The club leased a clubhouse which contained Turkish and Russian baths, steam rooms, solarium, swimming pools, a gymnasium, ball courts, a dormitory, club rooms, lounges, a restaurant, barbershop, and beauty salon. A dual membership and fee structure existed. Active members had exclusive voting rights and had complete control over operation of the health club. Associate members had no voice in management, or control, and paid almost all fees imposed by the club on the regular membership. It was concluded that the club was engaged in the selling of services to the general public (the "associate" members), and was operated for the profit of the few individuals

who constituted the active membership. Fees-for-services was the determining factor in deciding that the organization was engaged in business, and the club, therefore, was not exempt under IRC 501(c)(7).

The Service was also struggling with the issue of whether restrictions on use could be placed upon a recreation facility and the facility still qualify for IRC 501(c)(3) status. In Rev. Rul. 67-325, 1967-2 C.B. 113, the Service decided that restrictions on use on the basis of race were impermissible for a recreation facility if it was to be classified as exempt under IRC 501(c)(3). Rev. Rul. 67-325 is instructive since it recaps much of Rev. Rul. 59-310 on the way to finding that community recreation facilities may be classified as charitable, if provided for the general use of the community. Also, in Rev. Rul. 67-325, the community-wide benefit rationale for exemption was fully stated in a revenue ruling for the first time:

> "Providing a community recreational facility is in the general class of purposes which are recognized as charitable only where all members of the community are eligible for direct benefits,
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> "In this body of general law pertaining to purposes considered charitable only where all the members of the community are eligible to receive a direct benefit, no sound basis has been found for concluding that there would be an adequate charitable purpose if some part of the whole community is excluded from benefiting except where the exclusion is required by the nature or the size of the facility. Exclusion on the basis of race, religion, nationality, belief, occupation, or other classification having no relationship to the nature or the size of the facility, would prevent the purpose from being recognized as a sufficient public purpose to justify its being held charitable under this general body of law."

If facilities were unreasonably restricted, not only would IRC 501(c)(3) status be inappropriate, but also IRC 501(c)(4) status. See: Rev. Rul. 80-205, 1980-2 C.B. 184, in which the Service announced it would not follow Eden Hall Farm v. U.S., 389 F. Supp. 858 (W.D. Pa. 1975). Fees-for-services (doing business with the public) was also grounds for denial. See People's Educational Camp Society, Inc. v. Commissioner, 331 F. 2d 923 (1964), where, notwithstanding other aspects of

the organization promoting social welfare, IRC 501(c)(4) exemption was revoked. See also 1982 EO CPE, pages 249, et. seq.

On the other hand, the necessity for conferring a community-wide benefit in order for a recreation facility to obtain exemption under IRC 501(c)(3) also appeared contradictory to the treatment accorded IRC 501(c)(4) social welfare organizations and IRC 501(c)(7) social clubs, which operated some recreational facilities. As we have seen, social welfare organizations and social or recreation clubs that dealt with the public at large often were found to be doing unrelated business and therefore not exempt under the respective exemption provisions. This is not to be confused with IRC 501(c)(4) community service organizations that charge admissions for "related" activities. See the "roller rink" revenue ruling, Rev. Rul. 67-109, 1967-1 C.B. 136.

This apparent contradictory treatment was due in part to the fact that, prior to the Tax Reform Act of 1969, the unrelated business income tax provisions did not apply to either social welfare organizations or social clubs. For the IRC 501(c)(4) organization to be considered promoting social welfare, it could not charge on a fee-for-service basis unless its service activity was community related. At the same time, the IRC 501(c)(4) had to try to recoup expenses by producing sufficient income. In the case of the IRC 501(c)(7) social club, it had to be a membership organization and avoid tier fee structures in order avoid being found to be doing business with the general public while privately benefiting one class of its membership. With the Tax Reform Act of 1969, IRC 501(c)(4) and IRC 501(c)(7) organizations became subject to the unrelated business income tax provisions.

Today, IRC 501(c)(3) organizations are subject to a more liberal rule for carrying on unrelated trade or business because of the "primary purpose" test under section 1.501(c)(3)-1(e) of the Income Tax Regulations and Rev. Rul. 64-182, 1964-1 C.B. (Part 1) 186. Compare to IRC 501(c)(4) organizations which are subject to a primary activities test. See also 1982 CPE, pages 142 and 143. IRC 501(c)(7) organizations are now subject to a "substantially all" activities test and to special rules under IRC 512(a)(3).

(2) Rationale for Exemption of Health Clubs Under IRC 501(c)(3) Other than the Community Recreation Benefit Rationale

a. Educational

There is a long line of precedent revenue rulings dealing with "adjunct" recreation activities or facilities where the organizations qualified for IRC 501(c)(3) status as educational. Some of these revenue rulings, described what is commonly thought of as a health club or fitness center. The rationale for exemption under IRC 501(c)(3), in some of the revenue rulings, was the conduct of educational activities for the young. See: Rev. Ruls. 55-587, 1955-2 C.B. 261; 64-273, 1964-2 C.B. 142; 65-2, 1965-1 C.B. 227; 77-365, 1977-2 C.B. 192, and 80-215, 1980-2 C.B. 174. Where there were no educational activities or classroom instruction program, exemption under IRC 501(c)(3) could not be recognized. See, for example, Rev. Rul. 70-4, 1970-1 C.B. 126, where promotion of an amateur sport was found to be not educational, but, instead, the promotion of social welfare under IRC 501(c)(4).

b. Promotion of Sports Competition

Many of the revenue rulings cited in the previous section involved instruction of the young and not the promotion of sports. While Rev. Rul. 70-4 did represent one alternative to IRC 501(c)(3) exemption, the line of decisions shows a marked reluctance on the part of the Service to recognize IRC 501(c)(3) status where the primary activity was the promotion of sports. In short, it did not appear that such an activity could be found to be charitable under IRC 501(c)(3). It was not until the Tax Reform Act of 1976 (further amended in the Tax Equity and Fiscal Responsibility Act of 1982) that promotion of national or international amateur sports competition (fostering competition) was added as an independent basis for exempt status. See 1983 EO CPE Textbook, page 239.

c. Health Clubs and the Promotion of Health

The promotion of health was first recognized by the Service as an independent basis for exemption under IRC 501(c)(3) in Rev. Rul. 69-545, 1969-2 C.B. 117 (and amplified by Rev. Rul. 83-157, 1983-2 C.B. 94). This is a revenue ruling on hospitals which modified our previous position in the area set out in Rev. Rul. 56-185, 1956-1 C.B. 202, in which health care had been equated with an activity for relief of the poor. Since 1969, the promotion of health has been read more and more expansively. See 1980 EO ATRI, pages 25 through 27. In several of these situations, the exemption rationale of promotion of health was expanded beyond direct medical care. In Rev. Rul. 76-455, 1976-2 C.B. 150, for example, conducting health care planning and engaging in data collection in the health care area was sufficient grounds for exemption under IRC 501(c)(3). See also Rev. Rul. 79-358, 1979-2 C.B. 225.

Preventive health care or health maintenance was recognized by the Tax Court as a basis for IRC 501(c)(3) exemption in the case of Sound Health Association v. Commissioner, 71 T.C. 158 (1978). The Service contested this case because it was not apparent that there was a conferral of a broad public benefit. It appeared to have the aspects of a medical insurance program. The Tax Court found that the membership of Sound Health was synonymous with the community at large and that a donative element was therefore present. Sound Health was a health maintenance organization (HMO). The Service acquiesced in Sound Health in 1981-2 C.B. 2, on the issue of qualification for recognition of exemption under IRC 501(c)(3). A different result was reached however, where an HMO did not directly provide health care but instead paid a fee to an Individual Practice Association (IPA) (See 1983 EO CPE page 36, and 1979 EO ATRI page 216) to provide medical care. What follows is an excerpt from a GCM which considered the question of the extent of direct involvement in medical care and the scope of the community benefit needed to find promotion of health within the meaning of IRC 501(c)(3). NOTE: The G.C.M.s and private letter rulings excerpted herein are for illustrative purposes only and can not be used as precedent. IRC 6110(j)(3).

G.C.M. 39057
September 17, 1982

Issue

Whether a federally qualified health maintenance organization that arranges, but does not directly provide, comprehensive health services through an affiliated individual practice association in exchange for a prepaid premium from its subscribers is described in IRC 501(c)(3).

Conclusion

The organization described above is not organized or operated exclusively for charitable purposes, and thus fails to qualify for exemption from federal income tax under section 501(c)(3).

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Analysis

It is an established principle under the law of charitable trusts that the promotion of health constitutes a charitable trust and therefore is considered a charitable purpose within the meaning of section

501(c)(3). See Eastern Kentucky Welfare Rights Organization v. Simon, 506 F. 2d 1278 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26, 46 (1975). However, the "promotion of health" rule under the law of charitable trusts has two limitations. The first limitation is that there must not be a limited class of beneficiaries. In other words, the class must be sufficiently large so that the community as a whole benefits. Restatement (Second) of Trusts Section 368.1 Comment b (1959); IV A. Scott, Scott on Trusts Section 372.2 (3d ed. 1967) [hereinafter cited as Scott on Trusts]. Second, an entity which promotes health will not be considered charitable if it is conducted for the financial benefit of the owner. Scott on Trusts Section 372.1.

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In ***** G.C.M. 38735, EE-9-81 (May 29, 1981), we concluded that a health maintenance organization substantially similar to the one described in Sound Health Association v. Commissioner, 71 T.C. 158 (1978), can qualify for exemption under section 501(c)(3). The organization in Sound Health provided health care services to its members on a prepaid basis, and to non-members on a fee-for-service basis. The organization also handled emergency cases without regard to whether the patient was a member and also provided some health care services without charge or at an adjusted charge to fee-for-service nonmember patients unable to pay the full charge. The organization was open to both individual and group members. The Tax Court in Sound Health found that the health maintenance organization satisfied the organizational test in part because the purpose of the organization was to provide health care facilities for the ill and promote the general health of the community.

We have stated that the promotion of health can only be accomplished by an organization if its membership is "truly open to a sufficiently broad segment of the community served." G.C.M. 38735, supra at 11. The Tax Court in Sound Health concluded that there was benefit to the community because there was no meaningful limitation on becoming a member of that organization. In contrast to the organization in the Sound Health decision, the HMO in the instant case will prohibit individual membership for at least its first three years of operation. The HMO also does not possess any concrete plans for coverage of individuals eligible for medicaid and medicare. Instead, the HMO has chosen to restrict its services to private and government employer groups. The organization described in Sound Health maintained a subsidized dues program for the near poor and also provided some free care to

the poor. HMO, on the other hand, does not maintain any subsidized dues program and has made no arrangement for the medical treatment of the poor. Under these circumstances, it will be difficult to conclude that a sufficiently broad segment of the community benefits from HMO's activities.

In Sound Health, the Tax Court, indicated that the tests for determining whether a hospital should be exempt from tax were relevant in determining whether a health maintenance organization rendering medical care should be exempt under section 501(c)(3). The court then favorably compared Sound Health's operations to those of the exempt hospital described in Rev. Rul. 69-545. Although the health maintenance organization in Sound Health directly provided health care services, we believe that the criteria set forth in Rev. Rul. 69-545 are applicable in determining whether a health maintenance organization that arranges but does not directly provide health care services to its subscribers should be exempt under section 501(c)(3).

Rev. Rul. 69-545 described two hospitals, one of which was found to be organized and operated for charitable purposes (hospital A) and one which was found not to be organized and operated for charitable purposes (hospital B). The key characteristics of hospital A were that it had a public board of directors, an open medical staff, and provided health care services to anyone able to pay the cost of hospitalization, either directly or through third party reimbursement. Hospital A also provided emergency treatment to anyone without regard to a patient's financial status. On the other hand, hospital B was controlled by a group of physicians who limited hospital care to their private patients.

Another similarity between HMO and hospital B is that HMO has not made emergency health care arrangements for subscribers. This lack of coverage is the equivalent of limiting emergency health care to patients of physicians admitted by the medical staff of hospital B. This lack of coverage is also in contrast with the health maintenance organization in Sound Health which did not limit emergency treatment solely to members. While HMO plans to establish preventative health care programs for the public, it appears to be only an insignificant part of its overall activities. After weighing all of the relevant facts and circumstances in the instant case, it is apparent that HMO is markedly different from the health maintenance organization described in Sound Health.

The same considerations which resulted in the negative result on exemption under IRC 501(c)(3) in GCM 39057, supra, for failure to provide medical care

directly, are also present in the health club area. It has been argued that the health club, not carried on within the larger context of IRC 501(c)(3) activities benefiting the community, with its medically-supervised exercise programs is not unlike a health maintenance organization and should be exempt under the same rationale, that is, the promotion of health. The Service has not seen fit to advance the promotion of health rationale that far. The Service would distinguish between organizations, for which the promotion of health is a viable rationale for exemption, because the services of the organization directly involve the identification, diagnosis, care, treatment, and cure of physical and mental illnesses and disease, and those organizations such as health clubs which promote health more generally by providing for the maintenance of physical fitness through recreational exercises, notwithstanding medical evaluative testing before, during, and on completion of the various "fitness" programs.

The Service position is that the health club promotes health, but only in a manner that is collateral to the providing of recreational facilities, even where a community-wide benefit is conferred. While innumerable recreational activities may constitute a form of promotion of health in that exercise generally may assist in the prevention of illness and be consistent with generally recognized medical principles and conducive or beneficial to the soundness of the body and mind, it cannot be said that all such activities can be recognized as promoting health under IRC 501(c)(3).

Pursuant to discussion in Part (1) above, the basis for exemption of health clubs under IRC 501(c)(3) continues to rest on the rationale of conferring a community-wide recreational benefit.

3. Unrelated Business Income Tax Issues

A. Community Access to Health Clubs and Relatedness

An organization's failure to confer a community-wide benefit, if primarily organized and operated to run a recreation facility, may result in denial or revocation of IRC 501(c)(3) status. Rev. Ruls. 67-325, and 70-186, supra. For the recreation or health club facility carried on within the context of a program of charitable activity benefiting the community at large, however, the result can be either substantially related, and therefore not taxable, or taxable as unrelated, under the unrelated business income tax provisions. Rev. Rul. 79-360, 1979-2 C.B. 236, sets forth the position of the Service under the IRC 513(c) "fragmentation rule"

where the health club activity is carried on within the context of an overall charitable program of a community service organization.

Rev. Rul. 79-360

ISSUE

Is the operation of health club facilities by an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code, under the circumstances described below, unrelated trade or business within the meaning of section 513?

FACTS

The purpose of the organization and basis for its exemption under section 501(c)(3) of the Code as a charitable organization is to provide for the welfare of young people by the conduct of charitable activities and maintenance of services and facilities that will contribute to their physical, social, mental, and spiritual health, at a minimum cost to them or, where appropriate, at no cost to them. Membership in, and the services and facilities of, the organization are available upon payment of nominal annual dues.

The organization has recreational facilities that are used in its general physical fitness program. These facilities include a track, gymnasium, swimming pool, and courts for racquet ball, handball, and squash. Members use these facilities as often as they wish.

The organization has also organized a health club program that its members may join for an advance annual fee that is sufficiently high to restrict participation in the program to a limited number of the members of the community. The annual fee is comparable to fees charged by similar local commercial health clubs. The advance annual fee is in addition to the nominal annual dues for membership in the organization. Health club facilities include an exercise room, whirlpool, steam room, sauna, massage facilities, and sun room.

Those who are not health club members pay admission fees comparable to fees charged by similar local commercial establishments for each time they use any of the health club facilities.

LAW AND ANALYSIS

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the organization's need for income or funds or the use it makes of the profits derived) to the exercise or performance of an organization's purpose or function constituting the basis for its exemption under section 501.

Section 513(c) of the Code provides that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and that it is "substantially related", for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

The operation of the health club program is in addition to the organization's general physical fitness program. The commercially comparable annual dues or daily fees charged are sufficiently

high to restrict the health club's use to a limited number of the members of the community. Thus, the operation of the health club program does not contribute importantly, in the causal sense, to the accomplishment of the organization's exempt purposes.

Compare Rev. Rul. 76-33, 1976-1 C.B. 169, which holds that the rental of residential accommodations to certain classes of people by a similar organization is related to its exempt purposes and is not unrelated trade or business.

HOLDING

The operation of the health club facilities by an organization exempt under section 501(c)(3) of the Code, under the circumstances described above, is unrelated trade or business within the meaning of section 513 of the Code.

Controversy has arisen with regard to proper interpretation of Rev. Rul. 79-360. Specifically, what factors does the Service consider in determining whether an organization operating a health club will be subject to a tax on health club income under the unrelated business income tax provisions? Whether we are examining a two-tiered structure as described in Rev. Rul. 79-360, or a single club, the key to a favorable determination must be whether there is a conferring of a community-wide benefit through community access. This is a facts and circumstances determination that has to be made on a case-by-case basis. The charging of fees that are high, or which are above the level affordable by members of the community, is one indication that the health club activity is unrelated trade or business. A health club facility which differs substantially from that usually available to the persons served by the IRC 501(c)(3) organization's regular charitable programs is another factor leading to an unrelated trade or business determination. A health club which is operated in a manner similar to commercial health clubs is a factor to be considered. On the other hand, the presence or absence of commercial recreation facilities of a similar type in the immediate area could still lead to a favorable conclusion where there was sufficient community-wide access. Medical supervision of the health club program is another favorable factor.

B. An Illustrative Example of the Community Benefit Rationale Applied to Health Clubs

What follows is an illustrative example which analyzes factors to be taken into account in resolving whether the subject health club is unrelated trade or business activity. Although addressed to the dual fee or two-tiered facility, like that described in Rev. Rul. 79-360, the same facts and circumstances approach could be followed with the single facility structure. Examples of the single tier health club organization may be found in private letter rulings 8104091, dated October 29, 1980, and 8317104, dated January 28, 1983.

EXAMPLE

LEGEND:

M = Community Service Organization
x = 4000
y = 400

M is recognized as exempt from federal income tax under section 501(c)(3) of the Code. M's exempt purposes include providing for the welfare of people by the conduct of charitable activities and maintenance of services and facilities that will contribute to their physical, social, mental, and spiritual health. As one of the activities in furtherance of its exempt purposes, M operates a general physical fitness program to improve and maintain the health of the general public. This program provides access to fitness facilities, including a swimming pool, gymnasium, fitness area, weight training room, exercise room, and handball and squash courts. M solicits memberships from the general public for the use of its facilities. These memberships in the general physical fitness program are made available upon payment of a fee. M has x members in its general physical fitness program.

M maintains a two-tier membership structure for users of its fitness facilities. In addition to the facilities which M provides for its general membership, fitness facilities that are maintained separately from M's other facilities are provided to members of two separate health clubs within M. One is for men and the other health club is for women. Health club memberships are available to a limited number of persons who pay a significantly higher fee than the general membership. M has indicated that the memberships available for the health club facilities are restricted in number because of space limitations. During the year at issue, health club memberships totalled y. Unlike individuals who are

general members of M, the y health club members are entitled to use separate facilities which include a sun room, a steam room, and a sauna without payment of any additional fees. These services are available to non-health club users of the facility only if they pay extra fees during each visit to M. Health club members have access to a separate locker room, a separate exercise room, and separate showers. Unlike the general membership users of M, health club members have individual lockers. Several types of memberships are available in M as follows:\

M Membership Categories	Annual Membership Fees
Men (General)	$190
Men's Health Club	420
Women (General)	175
Women's Health Club	265

M operates substantial health and fitness programs and offers these programs under the supervision of qualified fitness specialists and medical professionals. M represents that the medical supervision is unique to M and other exempt organizations similar to M throughout the country. Most of these programs are offered directly by M to M's general membership although some are offered only to members of the health clubs. Two other commercial health clubs were identified in the same community. These other health clubs provided services to their members similar to those provided by the taxpayer. The commercial facilities charged rates for their services comparable to those charged by M for health club memberships.

M asserts that its medically-supervised health club programs promote health as is the case with the hospital described in Rev. Rul. 69-545, 1969-2 C.B. 117, and thus is an activity substantially related to M's exempt purposes.

Further, M argues, even if such activity is not held to promote health, the health club facilities of M are available to all segments of the community and thus a broad public benefit is conferred --- substantially related to the furtherance of M's exempt purposes. In support of this argument, M contends that its health club fees are set at a level within the financial reach of the local community as a whole. M further contends that the occupational and income makeups of the membership of M's health clubs is reflective of the occupational and income makeups of the population in the community served. To support this assertion, M has submitted occupational data of M's community from an appropriate state employment agency and compared it to M health club occupational

data from a survey of M's membership. Also submitted, was a comparison of U.S. Census Bureau family income percentage data of the M community with the M health club income membership breakdown data gathered from a survey of the health club membership.

Occupation	Population	M Health Club Members
Professional & Technical	40,360 (30.95%)	220 (33.10%)
Managers	23,370 (17.92%)	41 (9.98%)
Sales	20,830 (15.98%)	171 (17.79%)
Clerical	45,830 (35.15%)	54 (39.13%)

Annual Family Income	Percentage of Families in the Community served by M	Percentage of Health Club Members
Under $ 15,000	23.8%	14.1%
$ 15,000-$ 25,000	22.3%	22.4%
$ 25,000-$ 35,000	22.0%	22.0%
$ 35,000-$ 50,000	19.3%	16.5%
Over $ 50,000	12.5%	25.9%

Also submitted, was data from the Statistical Abstract of the United States that showed that discretionary recreational expenditures for an average American family, including, by inference the average family in M's community, was about $3,000. Also, the mean family income during the period in issue was $21,671 in M's community while the American mean family income was $19,461. It is asserted, based on this data, that the health club fees of M were clearly affordable to the average family in M's community.

M's IRC 501(c)(3) purposes include improving the physical, social, mental, and spiritual health of the community. In the general law of charity, the promotion of the happiness and enjoyment of the members of the community is considered to be a charitable purpose. Restatement (Second) of Trusts Section 374 (1959); IV A. Scott, The Law of Trusts Section 374.10 (3d ed. 1967). Generally, community recreational facilities are classifiable as charitable if they are provided for the use of the general public of the community. See, Rev. Rul. 67-325, supra, and Rev. Rul. 59-310, 1959-2 C.B. 146.

A major argument advanced by M is that the health club is substantially related to exempt purposes since it is an adjunct to M's medically supervised health and fitness programs and thereby promotes health.

The promotion of health is a charitable activity and organizations which promote health have been found to be exempt under section 501(c)(3) of the Code. See Rev. Rul. 69-545, supra. However, there is authority to the contrary where the activity in question is substantially equivalent to commercial activity. A major factor is whether the activity in question is an adjunct of a larger exempt activity. Also, an exempt entity can run a business for profit without adversely affecting exemption. The mere fact that an exempt charitable entity runs a business, as one of its activities, will not endanger exemption. However, this does not mean that the activity in question, when carried on as an adjunct to the larger exempt activities of an entity will be converted into a substantially related activity of the exempt entity for purposes of section 513(a). The applicable rule in this situation is the "fragmentation rule" under section 513(c) and section 1.513-1(b) of the regulations. It has been applied in Rev. Ruls. 73-105, 1973-1 C.B. 264, 78-98, 1978-1 C.B. 167 and, of course, the "health club" revenue ruling, Rev. Rul. 79-360, 1979-2 C.B. 236.

Here, M's health club operations promote health in a manner which is collateral to the providing of recreational facilities which advances the well-being and happiness of the community in general. While many of M's activities may relate to preventive and recuperative health care in the broad sense of being consistent with medical principles and conducive or beneficial to physical and mental soundness, the Service does not recognize such activities as promoting health within the meaning of section 501(c)(3) of the Code. On the other hand, M's health club operations may be characterized as charitable within the meaning of section 501(c)(3) because they are recreational, if they are for the benefit of the community at large. Additionally, even if it was recognized that M's health club operations did promote health under section 501(c)(3), a failure to benefit the community, as discussed below, would lead to the conclusion that the health clubs were not substantially related to charitable purposes consistent with Rev. Rul. 79-360, supra.

Therefore, if M's health improvement programs and recreational facilities and services are accessible to the general community, M's medically-supervised health clubs would contribute importantly to the achievement of M's exempt purposes. Facilities subject to the

use of both health club and general club membership (e.g., sun, steam, sauna, swimming pool, gym, etc.) comprise facilities which ordinarily play a standard part in providing comprehensive recreational and fitness programs. This is also true for the facilities subject only to the exclusive use of health club members (i.e., special exercise rooms, locker rooms, assigned lockers, shower rooms, and lounge), although such facilities are different from similar non-health club facilities in privacy and physical quality. In spite of the differences, however, the health club facilities function in the same manner and for the same purpose as corresponding general membership facilities.

An organization must benefit either the community in general or a charitable class within the community to be recognized as charitable. See: Restatement (Second) of Trusts Section 368, Comment b (1959); IV A. Scott, The Law of Trusts Section 374.10 (3d ed. 1967). This principle is manifest in section 1.501(c)(3)-1(d)(1)(ii) of the regulations which states that an organization is not organized or operated exclusively for one or more exempt purposes "unless it serves a public rather than a private interest." It follows that unless the community benefit requirement is satisfied by a particular trade or business carried on by a section 501(c)(3) charitable organization, such activity would constitute unrelated trade or business under section 513.

Charitable organizations that directly benefit the community often charge fees for goods or services that emanate from their charitable programs. In determining whether an activity constitutes unrelated trade or business, it must be determined that such activity accomplishes the exempt purposes of the organization. If the activity fails to accomplish the exempt purposes of the organization, it is unrelated trade or business regardless of the nature of the fees. If the activity promotes the organization's exempt purposes, the fact that fees are charged, even commercially comparable fees, does not detract from the "relatedness" of the activity unless the existence and magnitude of the fees charged preclude the general community from benefiting from the activity. If only a relatively small class of people in the community participates (e.g., relatively affluent group residing in a predominantly middle-income community), it cannot be said that there is requisite community benefit. See particularly Rev. Rul. 79-360, supra. In Rev. Ruls. 79-18 and 79-19, 1979-1 C.B. 194, 195, the Service held that organizations providing rental housing for the elderly and handicapped had to provide such housing within the financial reach of a significant segment of the elderly and handicapped in the community.

The primary problem in determining community availability is one of proof. Further, the community benefit test must be applied on a case by case, community by community basis. Charges that preclude sufficient accessibility in one community may not do so in another.

M has provided evidence of accessibility of the general community to M's medically-supervised health club facilities through comparison of membership income data with the income data of the community M serves. Also, occupation comparison data has been submitted. Facts indicate that the occupational/income makeup of M's health club memberships and the occupational/income makeup of the population in the community are substantially similar. Also submitted was information on discretionary recreational expenses that indicates that the average expenditure per American family recreational expenses was $3,000. M's community is a typical North Atlantic metropolitan area with an industrial and "white-collar" occupational base. The mean family income in M's community is substantially similar to the mean family income of the nation as a whole. The inference from these facts is that the health club fees of $420 for men and $265 for women are affordable by most segments of M's community.

Therefore, given all the particular facts and circumstances here, M's medically-supervised health clubs provide a community-wide benefit for the community M serves in furtherance of M's exempt purposes. The health club activity, in this particular case, is distinguishable from the health club activity described in Rev. Rul. 79-360, wherein comparable commercial fees were sufficiently high to restrict use of the club's facilities to a limited segment of the community. The operation of M's medically-supervised health clubs is substantially related to M's exempt purposes under section 501(c)(3) of the Code and does not constitute unrelated trade or business under section 513.

C. Checklist of Factors

The following factors, especially (2), are significant in making determinations of whether a community service organization health center is substantially related. A number of these factors were considered in the above example.

(1) Nature of the Facility

In the above illustrative example, operation of the health club facilities was conducted in a manner which was not readily distinguishable from operation of the regular facilities of the organization in which otherwise exempt activities were being carried on. This led to the conclusion that the facilities in question were not redundant and were in fact necessary to the carrying on of the organization's exempt program. On the other hand, large and significant differences in the layout of the facility, its design, operation, or location could very well have led to the opposite conclusion. In Rev. Rul. 79-360, supra, the facilities were sufficiently different to reach the opposite conclusion.

(2) Community Access

Most important is the factor of community accessibility. Community access not only has to be possible, but has to occur. Actual utilization should be proven. In the example, proof came in several forms. Demographic information and statistical community income data compared with membership characteristics of the health club facility was important in proving community access and availability of the facility. In the occupational makeup comparison, the percentages of health club members to those of the general population were very close for professional and technical, sales, and clerical occupations. Managers were under-represented. With income data, the percentages in the middle ranges were very close. The only comparison percentages on this chart to perhaps give pause were the "under $ 15,000" and "over $ 50,000" ranges. There was other evidence such as M being an average North Atlantic metropolitan area with average family incomes approximating the national average, and having families likely making average "discretionary recreational" expenditures. All these facts led to the conclusion that club membership was substantially representative of the community as a whole.

(3) "Charity" Memberships

A "charity" factor may be considered to show community benefit. See PLRs 8103091, dated October 29, 1980, and 8317104 dated January 28, 1983.

With a "charity membership" program, provision is made for the use of the facility for free or reduced fees by those unable to pay. In both PLRs cited above, the "charity membership" program was significant. It need not be a formal program so long as it is continuous and ongoing with significant numbers of individuals as participants. These, of course, are facts and circumstances determinations.

(4) "Guest Passes"

The EO specialist or examiner should also consider the effect of a "guest pass" or "trial membership" program. They may be directed to the tourist or transitory business visitor trade, not for bona fide community recreational programs or for building up the membership. These programs may constitute doing business with the general public and not be proof of broad public access. See also, Rev. Rul. 76-33, 1976-1 C.B. 169.

(5) Other Facts and Circumstances

The presence of medically supervised programs is another factor for consideration. Programs that are paid for by health insurance may be another. There may be other considerations.

(D) The "Unrelated" Health Club - What is Taxable?

(1) Where the conclusion is reached that the health club activity is unrelated, then the question becomes one of: What is taxable? In the unrelated unitary or single facility case the answer is obvious: all income minus appropriate deductions. More typical is the dual facility where the health club is determined to be unrelated such as in the situation described in Rev. Rul. 79-360, supra.

(2) In the case of the unrelated health club, that portion of the health club membership fee derived from the provision of the health club benefit constitutes income arising from an unrelated trade or business. This portion would be equal to the difference between the health club membership fee and the general membership fee for a particular member. In the example, if the health club activity had been classified as unrelated, the unrelated trade or business income derived from the fee paid by a male health club member would equal $230 (i.e., $420 men's health club fee) less $190 (men's general membership fee). Of course, these figures do not take into account any appropriate deductions.

4. Other Possible Community Service Organization Activities That May be Potentially Subject to UBIT

Community Service Organizations may engage in a number of trade or business activities beside the health clubs or recreational clubs discussed above that may or not be substantially related to exempt purposes. The following outline will note a number of these activities that could possibly be engaged in by these

organizations. It is possible that a particular organization may engage only in a few or perhaps none of these activities. It is noted that these are very factual areas to work in and each case is different. Most of the activities noted have been discussed in earlier EO ATRI/CPE Textbooks in conjunction with unrelated business income tax topics on other types of IRC 501(c)(3) organizations such as museums and universities. The outline will refer to the appropriate Textbook containing these discussions as well as illustrative disclosable PLR's and G.C.M.'s and recent revenue rulings and court decisions.

A. Rental of Dormitory Facilities to Young People, etc. as Opposed to Hotel Service for Visiting Trade or Business People, Tourists, etc.

(1) Rev. Rul. 76-33, 1976-1 C.B. 169 (G.C.M. 35601) is extracted below:

> **Unrelated income; rental of dormitory facilities.** The rental of dormitory rooms and similar residential accommodations, primarily to people under age 25, by an exempt organization whose purpose is to provide for the welfare of young people is substantially related to the purpose constituting the basis for the organization's exemption and does not constitute an unrelated trade or business within the meaning of section 513 of the Code.
>
> **Rev. Rul. 76-33**
>
> Advice has been requested whether, under the circumstances described below, the rental of dormitory facilities by an organization exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 constitutes unrelated trade or business within the meaning of section 513 of the Code.
>
> The declared purpose of the organization and basis for its exemption under section 501(c)(3) of the Code as a charitable organization is to provide for the welfare of young people by the conduct of charitable activities, and maintenance of services and facilities that will contribute to their physical, social, mental, and spiritual health, at a minimum cost to them, or where appropriate at no cost to them, by various desirable means. As one of its programs, the organization makes available facilities of study, recreation, and abode of homelike character, and a wholesome, decent environment and guidance designed to foster good citizenship and high ideals and character.

The organization rents dormitory rooms and similar residential accommodations primarily to young people under 25 years of age. Some rooms are rented, however, to low income persons who are over 25 years of age at a minimum cost to them. There are various types of accommodations ranging from single occupancy rooms with bath through multiple-occupancy rooms for which separate bath facilities that serve several such room units are available, to large halls suitable for rental to groups such as scout groups, for example, who sleep in sleeping bags on the floor.

The residence units are operated on and as a part of the same premises in which the organization carries on its social, recreational, and guidance programs. Membership in the organization, for which a nominal fee is charged, is required of those seeking room accommodations.

An applicant for residence signs a statement that he is in sympathy with the purposes of the organization and will abide by the rules and regulations which prohibit loitering, gambling, and use of alcoholic beverages. The dormitory facilities are under the management and supervision of career professionals who are trained to provide personal guidance and counseling. The residents are provided with personal counseling, physical education programs, and group recreational activities.

Section 513 of the Code defines the term "unrelated trade or business" as any trade or business, the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt purposes or functions.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "substantially related" only if the production or distribution of the goods or the performance of the services from which the gross income is derived contributes importantly to the accomplishment of the purposes for which exemption was granted.

Providing living accommodations with a wholesome and decent environment to young persons contributes importantly to the organization's purpose of providing for the welfare of young people. In addition, by making its rental facilities available at minimum cost to low income persons, regardless of their age, the

organization is assisting a recognized charitable class in a manner compatible with its exempt purpose.

Accordingly, the residency program is substantially related to the purpose constituting the basis for the organization's exemption and does not constitute unrelated trade or business within the meaning of section 513 of the Code.

B. Operation of Child Care Facilities

(1) Child care activity will likely constitute substantially related "educational" activity for taxable years after July 18, 1984 under IRC 501(k). See Topic A of this CPE Textbook on Tax Reform Act of 1984 changes for further discussion.

(2) For periods before applicability of IRC 501(k), child care activity may constitute unrelated trade or business activity unless the care was conducted with educational training or conducted for children from "needy" or low income families. See 1981 and 1983 EO CPE Textbooks, pages 64 and 18 respectively.

C. Travel Tours

(1) A "facts and circumstances" area controlled by degree of educational involvement in programs. See 1979 EO ATRI Textbook, Vol. 2, page 453.

a. Rev. Rul. 78-43, 1978-1 C.B. 164, describes commercial travel services subject to tax on unrelated business income.

b. G.C.M. 38949, dated July 16, 1982, describes substantially related educational travel tours.

(2) In Retreat in Motion v. Commissioner, T.C.M. 1984-315, filed June 21, 1984, CCH Private Foundation Reporter, paragraph 7537, an IRC 501(c)(3) 7428 case, the court found that applicant failed to meet burden of proof in attempt to convince that substantial time devoted to secular sightseeing activities, to beach-going and mountain climbing, was in furtherance of applicant's primary purpose of providing Christian fellowship and teaching.

(3) Notwithstanding the relatedness issue, if tours are held only once or twice a year, the "intermittent" rule under Reg. 1.513-1(c)(2) may be applicable. The activity would likely escape taxation because of not being regularly carried on. See 1982 EO CPE Textbook, page 127.

D. Cafeterias, Restaurants, Bake Shops, Vending Machines, etc.

(1) Food services may be substantially related if they allow participants to spend more time engaging in otherwise exempt activities of the subject organization. See Rev. Rul. 74-399, 1974-2 C.B. 172.

(2) Food services may also escape classification as unrelated trade or business if for convenience of "members" or "employees". IRC 513(a)(2). See also Rev. Rul. 81-19, 1981-1 C.B. 353.

(3) General discussion of food service activities may be found in 1979 EO ATRI Textbook, Vol. 2, page 486, and 1980 EO ATRI Textbook, page 214.

E. Shops

(1) To escape classification as unrelated trade or business, individual sales must "contribute importantly" to community service organizations' exempt purposes under IRC 513(c) "fragmentation" rule.

(2) Thorough discussions in this area may be found in 1979 EO ATRI Textbook, Vol. 2, page 486; G.C.M. 38949, July 16, 1982; Rev. Ruls. 73-104, 1973-1 C.B. 263, and 73-105, 1973-1 C.B. 264; and PLR's 8303013, 8107006, 8024111, and 8252011.

(3) Certain sales incidental to community service organizations may fall into the IRC 513(a)(2) convenience exception if sold to members or employees. Sales may also be substantially related if sales directly assist participants in community recreational activity that is substantially related to exempt purposes. "Pro shop" sales of running shoes, for example, would likely not be classified as unrelated trade or business if sold in conjunction with exempt fitness activity.

(4) The IRC 513(a)(1) and (a)(3) exceptions from unrelated trade or business for sales activities run with substantially all volunteer labor or donated

goods may be applicable here. See 1982 and 1983 EO CPE Textbooks, pages 124 and 89, respectively.

F. Miscellaneous

(1) Parking Lots

a. If paying participants are engaging in exempt activity of the organization, parking lot program may be substantially related. Convenience exception under IRC 513(a)(2) may alternatively be applicable for members and employees. See 1979 EO ATRI Textbook, Vol. 2, page 486; Rev. Rul. 69-267, 1969-1 C.B. 160.

b. If otherwise unrelated, parking lot activity with general public may escape taxation if no services are provided. Rent modification under IRC 512(b)(3)). See Reg. 1.512(b)-1(c)(5).

(2) Barbershops, Beauty Services, Flowershops

a. Generally these activities are unrelated unless provided under certain conditions for a charitable class such as elderly. See Rev. Rul. 81-61, 1981-1 C.B. 355. Compare to Rev. Rul. 81-62, 1981-1 C.B. 355. See discussion on organizations providing services for the elderly in 1979 EO ATRI Textbook, page 234.

(3) Sale or Rental of Mailing Lists

a. Generally these activities are classified as unrelated trade or business. See Rev. Rul. 72-431, 1972-2 C.B. 281

(4) Other "Commercial" Recreational Activities

a. Rev. Rul. 79-361, 1979-2 C.B. 237 describes an unrelated miniature golf activity carried on by an community service organization. The revenue ruling is extracted below.

Unrelated income; miniature golf course. The operation of a miniature golf course in a commercial manner by an organization exempt from tax under section 501(c)(3) of the Code, whose purpose is to provide for the welfare of young people, constitutes unrelated trade or business under section 513.

Rev. Rul. 79-361

ISSUE

Is the operation of a miniature golf course by an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code, under the circumstances described below, unrelated trade or business within the meaning of section 513?

FACTS

The purpose of the organization and basis for its exemption under section 501(c)(3) of the Code as a charitable organization is to provide for the welfare of young people by the conduct of charitable activities and maintenance of services and facilities that will contribute to their physical, social, mental, and spiritual health, at a minimum cost to them or, where appropriate, at no cost to them. Membership in, and the services and facilities of, the organization are available upon payment of nominal annual dues.

As one of its activities, the organization operates a miniature golf course that is open to the

general public. The operation of the miniature golf course, which is managed by salaried employees, is substantially similar to that of commercial miniature golf courses. The admission fees charged are comparable to the fees of similar commercial facilities and are designed to return a profit.

LAW AND ANALYSIS

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of any organization for income or funds or the use it makes of the profits derived) to the exercise or performance of an organization's purpose or function constituting the basis of its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related", for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

The above organization's operation of the miniature golf course in a commercial manner does not contribute importantly to the accomplishment of its charitable purpose.

Compare Rev. Rul. 76-33, 1976-1 C.B. 169, which holds that the rental of residential accommodations by a similar organization is related to its exempt purposes and is not unrelated trade or business.

HOLDING

The operation of a miniature golf course by an organization exempt under section 501(c)(3) of the Code, under the circumstances described above, is unrelated trade or business within the meaning of section 513.

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b. Rev. Rul. 78-98, 1978-1 C.B. 167 describes an unrelated ski facility activity carried on by an educational organization. See 1980 EO ATRI Textbook, page 214.

(5) Insurance Activities

a. Organizations procuring group insurance for members may be engaged in unrelated trade or business. See 1982, 1983, and 1984 EO CPE Textbooks, pages 285, 256, and 362 respectively. See especially Carolinas Farm and Power Equipment Dealers Association, Inc. v. United States, 699 F 2d 167 (4th Cir. 1983). See 1981 EO CPE Textbook, page 272 for background. Illustrative PLR's include 8302009 and 8302010.

(6) Rental Activities

a. If rental facility is debt financed, the rental income may be subject to taxation pursuant to IRC 514.

(7) Advertising Activity

a. If organization has educational publication with advertising, it may be subject to taxation on advertising

income. See Topic I in this 1985 EO CPE Textbook on Recent IRC 513 Developments in Advertising.

(8) "Other" Activities

a. Income producing activities are restricted only by imagination and limiting facts and circumstances.

4. Conclusion

This topic has discussed a variety of income producing activities of community service organizations, particularly health clubs and similar recreational programs. This is a facts and circumstances area and each case is different. Whether exemption is jeopardized, or, more likely, whether there is unrelated trade or business taxable income requires close scrutiny and weighing of all facts.